CHAPTER 1

Keep Calm, Carry On . . . and Complete the Regulatory Reform Agenda

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Support for the postfinancial crisis reform agenda has been waning in recent years, resulting in part from three assertions by critics in the financial industry. The first is that much of regulation is unnecessary and detrimental. The second is that regulation is necessary, but it's gone too far and therefore is excessive. The third is that the postcrisis regulatory reforms were necessary, but the uncertainty caused by continuing discussions on the scope and timelines of the agenda is turning out to be counterproductive.

In our view, the regulatory revolution that has taken place since the crisis has not just been necessary but has been essential to underscore the safety of the global financial system and for reviving a sustainable global economy over the medium and long term. As to whether it's gone too far, the work has not yet been completed, as some parts of the agreed reforms still have not been fully implemented and agreement still has to be reached on some reforms, although a decade has now passed since the events that triggered the financial crisis.

One aspect of the reform process that has been truly unprecedented, and often forgotten, is how it has changed the established approach to regulatory design and implementation in an inclusive and meaningful manner in at least four dimensions.

First, the process has been truly global in the sense that not only advanced economics, but emerging markets and developing economies (EMDEs) have been sitting together at the table and designing the global regulatory framework. The Group of Twenty (G20), which has driven the agenda, has the major EMDEs as its members, and both the Financial Stability Board (FSB) and the Basel Committee have expanded their membership to include the major EMDEs. In addition, the FSB has used its Regional Consultative Groups, which comprise

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other countries not around the main table, to bring a more global perspective to the discussions.

Widening the standard-setting table has been an impressive gain for the international financial architecture, given that both providers and users of finance are no longer confined to national boundaries. Many financial institutions are global in their presence and their activities, and in many cases EMDEs represent their major markets. Having their input into the design of global financial policies can help encourage greater inclusion and a more-level playing field.

However, it is not necessary that the regulatory standards be implemented mutatis mutandis across all countries. Their implementation requires both an application of proportionality and of common sense, and a distinction needs to be made between adaptation and rigor.

The objectives of the regulations being developed by global standard-setting bodies have a purpose that should be shared by all countries. But in terms of adapting the regulations to a specific national context, one needs to look at the economic and financial reality of that country and then adopt an approach that makes sense for that country.

Being flexible on the adaptation of international standards does not mean that the standards applied in a particular country should be weaker for that country. Some EMDEs ask why they should adopt the postcrisis reform agenda when the crisis did not originate in their jurisdictions or even, in some cases, did not affect them directly. The answer is that EMDEs could be subject to more risks in general because the preconditions necessary for safe, sound, and efficient financial systems may still be developing. For example, the IMF Financial Sector Assessment Programs' work suggests that legal frameworks in many EMDEs cannot yet provide quick relief in the case of infringement of creditor rights or contractual certainty. These countries may also face capacity constraints in the development of independent professions that support the conduct of finance, including auditing and accounting. In addition, EMDEs may face certain macrorisks like those associated with reversals of international capital flows.

Such reasons argue for a level of rigor that is consistent with ensuring the resilience needed in a high-risk environment. This rigor is required not only from the point of view of the country but also as a global public good, because if some constituencies or jurisdictions are subject to lower rigor in terms of standards, they could end up importing high-risk activities. This arbitrage could lead to an additional accumulation of risk in those jurisdictions with lower standards. Hence, it is important to combine the adaptation and the flexibility dictated by common sense as well as preserve the level of rigor to ensure the resilience of these financial systems.

There is also the question of developing adequate institutional capacity in these countries. This is an area where both the IMF and the World Bank provide a lot of technical assistance to help countries adopt these global regulatory standards after appropriately adapting them to their national contexts. The analysis that we've conducted at the IMF in terms of EMDEs on the role of the interaction between regulation and financial deepening, and regulation and financial

inclusion, shows that for financial deepening to be consistent with financial stability, it must be accompanied by strong prudential frameworks. And for financial inclusion not to give rise to problems in terms of systemic stability down the road, it is better if accompanied by a sound regulatory framework. For all of these reasons, having sensible, flexible, but rigorous regulation is critical in EMDEs.

The second major dimension of regulatory change is that the scope of the reform agenda has been broad and not just confined to a few areas like banking. Given the origins and channels of transmission of the shocks of the crisis, reform has covered many areas of financial activity that probably have not been looked at in such an integrated manner. In terms of areas of intervention, it has covered banks and nonbanks (including the shadow banks that lie in between), financial institutions and financial markets, financial inclusion and consumer protection, accounting and auditing standards, and incentives and compensation.

One of the defining features of this crisis has been the role played by shadow banks. This area had not been well studied or understood previously. Shadow banking is especially tricky to handle from a regulatory point of view, given the diversity of activities and players, with the playing field constantly mutating and even gaining ground. If one looks at the growth rate of so-called shadow banking activities—understood as those outside of the banking system that entail either maturity or liquidity transformation or the buildup of leverage, and which are not adequately or sufficiently regulated—at the global level, it is 10 times faster than that of banking activities.

Why is this happening? Based on work at the IMF, in terms of understanding the drivers of shadow banking at the global level, we come up with three fundamental drivers. The first is the regulation put in place in banking, leading to a shift in activity toward nonbanks and particularly shadow banks. The second is the accommodative monetary policies of recent years in advanced economies, which are appropriate but have led many investors to move from banks to nonbanks to gain higher rates of return. But, of course, with high rates of return also come associated higher risk and, in particular, higher liquidity risk, which is important in shadow banking and, especially, in asset management. The third driver, which is most important for EMDEs, is financial development, which has led to a proliferation of nonbank activities and shadow banking activities. China is a quintessential example of an EMDE where shadow banking has been gathering strength significantly.

The role of shadow banking in finance can be likened to the role that cholesterol plays in human biology. There is a good part and a bad part. The good part supports market-based finance and should be maximized. At the same time, the bad cholesterol has to be minimized given its contribution to systemic risk. In the case of shadow banking, systemic risk is embedded in the characteristics or functions that shadow banks perform, but which are not adequately regulated. The challenge facing policymakers and the FSB has been deciding which approach should be followed. Should it be the same approach as in banking and be entity-based? Or given that shadow banking is so heterogeneous and so constantly mutating, should not regulation be primarily an activity-based approach?

These questions highlight the big difference between the regulation of banking and of shadow banking, and increasingly there is support for a focus on activity-based rather entity-based regulation for shadow banking. Such an approach affords the flexibility in addressing the boundary problem—posed, for example, by financial technology, whose activities are, in some cases, in the shadows of the shadow banking system.

One segment of the shadow banking space that poses special policy challenges is the regulation of the asset management industry. The application of the activity-based framework means that one needs to first gather better and more granular information regarding the liquidity of the underlining assets. Second, progress has to be made in having adequate management of liquidity inside mutual funds and having adequately developed stress-testing techniques for mutual funds that take into account not only partial equilibrium approaches but also general equilibrium approaches. What happens when there is a large-scale withdrawal from just one fund that triggers withdrawals from other funds, leading to everyone trying to sell and exit? Finding a good response to this is important, as the first-mover advantage problem poses grave potential for runs on mutual funds. These risks are among those that the FSB is discussing. We expect to see the appropriate regulatory response to dealing with them while keeping in mind that some investors are expected to have a greater risk tolerance than others. Many initiatives are in the pipeline and will lead to a safer shadow banking system by transforming shadow banking into a resilient, stable source of market-based finance.

The third dimension of change is that regulatory reform has been deep, with very fundamental changes in how the financial system is now regulated compared to the past. Probably the most salient example of this has been the focus on systemic risk and systemically important financial institutions. This focus has come from the shared objective of ending the "too-big-to-fail" syndrome, given the moral hazard associated with it and the burden that this potentially places on the taxpayers in the event of their failure. The dimensions of the response, in addition to regulation, has also included guidance on supervision, governance, and resolution of the systemically important financial institutions, although with differing emphases and results.

One of the most salient and controversial issues surrounding the global financial crisis is the "too-big-to-fail" problem. Given the very serious difficulties that systemically important financial institutions had during the crisis, the authorities were put in an extremely challenging position. They had to choose between letting these institutions fail, with the associated adverse impacts on the economy and on society, or rescuing them by using taxpayers' money and paving the way to the consolidation of moral hazard, in the sense that profits are privatized in good times and socialized in bad times. It is no wonder that one of the key goals of the regulatory reform process, launched at the peak of the crisis and coordinated by the FSB at the behest of the G20 leaders, has been to address and, if possible, to end the too-big-to-fail problem, which has been re-baptized in more

politically correct terms as dealing with systemically important financial institutions.

There is no doubt that a lot has been achieved. The approach toward the too-big-to-fail issue has advanced significantly across four domains. The first is in terms of regulation, which requires, for example, that systemically important institutions hold more high-quality capital as a surcharge for their enhanced contribution to systemic risk. This has resulted in much stronger financial institutions, particularly banks, regarding both solvency and liquidity. The second is more effective supervision, led by the work of the Supervisory Intensity and Effectiveness work stream of the FSB, which has laid out the framework for more intrusive supervision for the systemically important institutions. Third, there have also been improvements—though not as numerous as many of us would have liked—in terms of corporate governance of financial institutions and particularly of banks.

Last, but certainly not least, there has been considerable movement on resolution. And there, the progress has come together with the establishment of "living wills" and the focus on the recovery and resolvability of financial institutions and particularly of global systemically important banks. What has also been revolutionary has been the agreement on the total loss-absorbing capacity, which is a welcome step toward reinforcing the capacity of big banks to be resolved without causing problems for the economy or costing taxpayers money. Also important is the agreement on the Key Attributes for Effective Resolution, which represents the first-ever international code of best practices on cross-border resolution, an area in which the IMF and the World Bank have long been interested.

However, having said that, there is still more work to be done on resolution, particularly at two levels. The first is further advancing the policy development at the international level to deal with resolution of nonbanks such as insurance companies and financial market infrastructures like central counterparties, which can concentrate systemic risk. Second, gaps remain in the national regional frameworks in implementing the agreed-upon international standards on resolution. The application is rather uneven and significant obstacles remain regarding cross-border resolution. There also is a need for a fuller alignment of the national and regional frameworks with the Key Attributes for Effective Resolution, both in terms of both technical and legal changes.

Another area where more still needs to be done is addressing misconduct in finance. This area is not confined to systemic institutions but has been discussed most often in their context, given the key role they play in setting global benchmarks, making key markets, and in the sheer headline number of losses attributed to excessive risk taking, mis-selling, and misconduct. While stricter enforcement of violations is one element of the response, a broader issue to be addressed is how to move from just enforcing a culture of compliance to promoting a culture of ethical conduct guiding the provision of finance. When we talk about culture and human behavior, we have to find ways to get beyond incentives, sanctions, and exhortations to move actions in the right direction. In the end, this is an issue that transcends our regulatory approaches, which has to do with setting the tone

at the top and with identifying subcultures that encourage excesses. This is going to be extremely difficult, but setting the right objectives and reinforcing them through constant public discourse will help get us to a better place than the current situation. The goal is that people do the right thing even when no one is watching.

And last, but certainly not least, the reforms have been done in a compressed time period, compared to earlier efforts, especially considering the reach, scope, breadth, and depth of the changes. There has also been a conscious attempt to provide for a longer implementation period, driven both by the external environment but also to allow industry the time needed to bring about meaningful change. Although the regulatory revolution has taken place in a short period of time, it has been more realistic in terms of the speed with which implementation can be expected.

Take the example of the Basel capital framework. The official discussions on the Basel II framework began in 1998, and the final rules text was issued in 2004 with an implementation date of 2006. Basel III, on the other hand, was issued in December 2010, just two years after the crisis took on a full-blown form, but allowed for the rules to be implemented in a phased manner over a seven-year period, starting in January 2013. This has proved helpful in finalizing the efforts to strengthen the banking system, which is the core of the financial system, and to make it truly resilient. Yet, it also needs to be recognized that often market pressure often has led to faster de facto implementation of the reforms by the industry than envisaged in the original official timetable.

The phased-in period has allowed also for the quality of the implementation to be assessed. The Regulatory Consistency Assessment Program, launched by the Basel Committee, looked at how implementation was progressing and found excessive variability in the risk-weighted assets—computed using internal models of some of the Group I banks—that could not be explained by national differences. Allowing this to continue would have put the entire capital reform in jeopardy and could have triggered a race to the bottom in a fiercely competitive environment. The consequent focus on the denominator of the capital ratios (getting the risk-weighted assets right) has been a key instrument in the quest for a level playing field, now that so much progress has been made on the numerator of the capital ratio (the amount of loss-absorbing capital) in enhancing the quantity and the quality of capital.

A sensible approach to this issue will allow credibility to be restored to the risk-weighted assets framework, which is the basis for many of the bank-based reforms, while maintaining the risk-sensitive approach that was introduced by Basel II.[1] However, this has meant reopening some of the issues that had been dealt with by Basel III and has led to calls for regulatory certainty. Such certainty

[1] Agreement has since been reached on necessary enhancements to the Basel III framework, which limit the use of the output of banks' internal models in regulatory capital calculations that were the source of much of the excessive variability. These enhancements are required to be implemented in a phased manner between 2022 and 2027.

is indeed important for finance to function with a longer-term perspective, but it is also important to adapt the framework to the lessons learned from implementation, so that in the end we have a robust framework. And, of course, while certainty is desirable and a goal worth striving for, it can be an elusive construct given the dynamic dialectic that exists between regulation and innovation.

Without a doubt, there has been a substantial change in the regulatory landscape, and this has been warranted. What is most important is that each and every one of these changes can be mapped back to a deficiency or gap in the regulatory framework that was exposed in the crisis. Not to address these gaps would not just be an omission—it would put the global financial system at risk. On the other hand, while much distress has been expressed on how capital requirements are affecting the ability of banks to lend, several studies have concluded that well-capitalized banks do better in performing the intermediation function, underscoring a key objective of the reforms, which was to build resilient, well-capitalized financial institutions.

What is important, however, is to continuously monitor and periodically assess how these multiple changes are playing out and to correct for any unintended effects that may run counter to the objectives of the reforms. Efforts are underway to take a comprehensive view of the effects of the reforms, but what we can already see in terms of the ultimate objective of regulation—which is to move the financial system toward a safer place—is that the banking system is now considerably safer than it was a few years ago. Further, while more still needs to be done in securing the safety of nonbanks, overall the major financial systems have demonstrated resilience in the face of the recent global shocks, and the volatility associated with these episodes has been short-term and has not adversely affected them. So what is clear is that the financial system is on the right path to achieving the goals of the reform agenda.

All in all, we conclude that the financial system is in a much better place than it was a few years ago. And the regulatory reform agenda has been necessary to getting us here. Now it is important to complete and implement that agenda swiftly so a robust framework is in place that can address existing and emerging risks and vulnerabilities. In doing so, we need to keep in mind the need to safeguard the stability of the financial system while allowing it to play its role in supporting sustainable economic growth.